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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Stepan Company Fourth Quarter and Full Year 2017 Earnings. (Operator Instructions) As a reminder, this conference is being recorded, Thursday, February 22, 2018.

I would now like to turn the conference over to Matthew Eaken, Vice President and Interim CFO. Please go ahead, sir.

Matthew John Eaken - *Stepan Company - Corporate Controller, Interim VP & CFO*

Good morning, and thank you for joining the Stepan Company's Fourth Quarter and Full Year 2017 Financial Review. Before we begin, please note that information in this conference call contains forward-looking statements, which are not historical facts. These statements involve risks and uncertainties that could cause actual results to differ materially including, but not limited to, prospects for our foreign operations, global and regional economic conditions and factors detailed in our Securities and Exchange Commission filings.

Whether you are joining us online or over the phone, we encourage you to review the investor slide presentation, which we have made available at www.stepan.com under the Investor Relations section of our website. We make these slides available at approximately the same time as when the earnings release is issued, and we hope that you find the information and perspectives helpful.

Now with that, I would like to turn the call over to F. Quinn Stepan, Jr., our Chairman, President and Chief Executive Officer.

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

Thank you, Matt. Good morning, and thank you all for joining our call today.

2017 was a good year for Stepan Company. The company delivered record reported and adjusted net income for 2017, and we now have had record income for 7 of the last 10 years. Reported net income in 2017 was $91.6 million, up 6% versus last year despite the $14.9 million unfavorable net impact of the new U.S. Tax Cuts and Jobs Act's legislation.

Adjusted net income was $108.7 million, 11% higher than 2016. Adjusted net income as a percent of net sales was 5.7%, an increase of 10 basis points versus 2016.

Improved product mix, increased asset utilization and enhanced internal efficiencies continued to drive results. Both Surfactants and Polymers benefited from our diversification strategy, and we anticipate further contributions in 2018.

For the full year, Surfactants delivered record operating income due to an improved product mix, lower manufacturing costs and the accretive impact of our 2016 Brazil acquisition. Sales benefited from our diversification efforts into Functional Products, higher sales within the household, industrial and institutional end markets and continued growth in more specialized applications.

During the fourth quarter of 2017, the company approved a plan to restructure a portion of our production activities at our Fieldsboro facility. We transitioned impacted products to other Stepan sites in North America, and we expect to benefit from improved asset utilization and a reduced cost base going forward.

Polymers delivered its second best full year results despite increased competitive pressure and higher raw material costs within our North American Polyol business. Global Polyol volumes were up slightly, despite share loss in North America. The market for insulation materials remains strong due to continued global energy-conservation efforts.

The definitive agreement with BASF to acquire its surfactant production facility in Ecatepec, Mexico is on track to close this quarter. We believe the acquisition will significantly enhance our market position and supply capabilities for surfactants in Mexico and position us to grow in both the consumer and functional end markets.

Our Board of Directors declared a quarterly cash dividend on Stepan's common stock of $0.225 per share, payable on March 15, 2018.

At this point, I would like Matt to walk through a few more details about our fourth quarter and full year results.

Matthew John Eaken - *Stepan Company - Corporate Controller, Interim VP & CFO*

Thank you, Quinn. My comments will generally follow the slide presentation. Let's start with Slide #5 to recap the quarter. As Quinn stated, adjusted net income for the fourth quarter 2017 was a record $24.6 million, or $1.06 per diluted share, a 100% increase versus $12.3 million, or $0.52 per diluted share, in 2016. Because adjusted net income is a non-GAAP measure, we provide full reconciliations to the comparable GAAP measures and these can be found in Appendix 2 of the presentation and Table 2 of the press release.

Specifically, regarding adjustments to reported net income, this quarter included deferred compensation income of $1 million, or $0.04 per diluted share, compared to deferred compensation expense of $2.7 million, or $0.11 per diluted share, in the same period last year. Naturally, all employee compensation expenses are reflected in our normal operating income. However, we allow employees the opportunity to defer their incentive payouts until some future date and the future payment changes based on the company's stock price. When the stock price declines, income is generated as we mark this item to market value. Because the future liability of employee compensation only changes consistently with the change in the stock price, we exclude this item from our operational discussion.

The new U.S. Tax Cuts and Jobs Act legislation resulted in a net onetime expense of $14.9 million, or $0.64 per diluted share. The current quarter results also included $800,000, or $0.04 per diluted share, of after-tax business restructuring charges. These charges related to decommissioning costs from the closure of our Canadian plant announced in 2016 and severance costs associated with the partial restructuring of our Fieldsboro site. We expect an additional $2 million to $3 million of after-tax restructuring charges in 2018 related to decommissioning cost at these plants.

Slide 6 shows the total company earnings bridge for the fourth quarter compared to last year's fourth quarter, and breaks down the increase in adjusted net income. Because this is net income, the figures noted here are on an after-tax basis. Fourth quarter 2016 results were negatively impacted by $8.9 million of pretax nonrecurring costs, of which $8.3 million impacted Surfactants and $600,000 impacted Polymers. In addition, fourth quarter 2017 results were positively impacted by $4.7 million of pretax income related to the favorable resolution of a Surfactant product claim in Europe. We will cover each segment in more detail, but Surfactants and Polymers were up, while Specialty Products was down versus the prior year.

The bridge on Slide #6 excludes the impact of the new tax reform legislation because the onetime cost was excluded to arrive at adjusted net income. Therefore, excluding the onetime impact, our effective tax rate did not significantly impact results for the quarter. For the full year, our effective tax rate was 34.3% in 2017 compared to 24.3% in 2016. This increase was primarily attributable to the enactment of the U.S. Tax Cuts and

Jobs Act, which resulted in a net tax cost of $14.9 million in 2017. The onetime net impact was comprised of a $19.4 million transition tax expense on certain unrepatriated earnings of foreign subsidiaries, partially offset by a $4.5 million favorable impact related to the remeasurement of a net U.S. deferred tax liabilities at a lower future corporate tax rate. The increase in the effective tax rate in 2017 was partially offset by favorable nonrecurring discrete items.

We expect the effective tax rate to be in the range of 20% to 23% in 2018.

Our material on Slide #7 focuses solely on the Surfactant results of the segment for the fourth quarter. Surfactant net sales were $324.2 million, up 15% from the same quarter a year ago. Prices were 11% higher due to the pass-through of certain raw material costs. Sales volumes were up 2%, mainly due to higher demand in the Functional Product end markets and higher sales through our distribution partners. This increase in volume was partially offset by lower consumer product commodity volumes. The positive translation impact of a weaker U.S. dollar increased sales by the remaining 2%. The segment delivered $28.3 million of operating income, a 94% increase over the prior year quarter, mainly driven by $8.3 million of nonrecurring expenses in the prior year, settlement of a European product claim, savings from the Canadian plant shutdown and improved product mix and growth in agriculture end markets in Europe. The prior year acquisition in Brazil also contributed positively.

In the bridge, we showed North America and Asia in the same category because our Surfactant business in Asia is relatively small and much of the Surfactant production in the region is used to support business in the United States. North American results were positively impacted by higher demand for oilfield products, sales through our distribution channel as well as savings from the Canadian plant shutdown. Latin American results were up slightly due to accretive income related to the Brazil acquisition in 2016. European results were higher year-over-year due to improved product mix and growth in agricultural chemicals.

The $11.4 million of nonrecurring costs primarily relate to the year-over-year impact of the Surfactant product claim commitments in Europe, recorded in the fourth quarter of 2016 and the positive impact due to the favorable resolution of one of the claims in the fourth quarter of 2017.

Now turning to Polymers on Slide 8. Net sales were $131.1 million, up 13% from the same quarter a year ago. An 8% increase in selling prices was related to the pass-through of higher raw material costs. Sales volume was up 1%, primarily due to higher European Rigid Polyol volume and higher global Specialty Polyol volume, which was partially offset by lower North American Rigid Polyol and phthalic anhydride volumes. Foreign exchange translation positively impacted net sales by 4%. Operating income was $19 million compared to $16.5 million in the same quarter last year. The increase was primarily due to a 2% increase in global polyol volumes.

Global Rigid Polyol volumes increased despite share loss in North America. Global Specialty Polyol volumes increased supported by the capacity addition in Poland. Operating income in North America was negatively impacted by higher raw material costs during the quarter. European results continued to improve due to higher Rigid and Specialty Polyol volumes and slightly higher margins. Phthalic anhydride results increased despite lower volume and margins due to the nonrecurrence of costs associated with the scheduled maintenance shutdown in the fourth quarter of 2016. The nonrecurring expense of $600,000 represents remediation costs in the fourth quarter of 2016.

Specialty Product operating income decreased $2 million for the quarter, primarily due to the timing of orders in our flavor business and lower volume and margins in our food business.

We will now take a moment on the Slide #9 to recap the full year 2017 financial performance. Adjusted net income was, again, a record of $108.7 million, or $4.65 per diluted share, an 11% increase from $98.2 million, or $4.25 per diluted share, in 2016.

Surfactant operating income was a record $120 million, up 20% from 2016. The increase was due to $10.2 million of nonrecurring expenses in the prior year, settlement of a European product claim in 2017, growth in key global markets and savings from the Canadian plant shutdown.

The Polymer segment delivered $82.8 million of operating income, a 14% decrease versus prior year. Polymer results for 2017 were the second best on record. The decrease versus last year was primarily due to higher raw material costs despite higher European Rigid Polyol and global Specialty Polyol volumes.

Specialty Product operating income was $10 million versus $10.7 million in the prior year.

Slide #10 shows the total company earnings bridge for the full year 2017 compared to 2016. Like the quarterly bridge, the figures here are noted on an after-tax basis.

Turning to Slide #11. It is important to note that our balance sheet remains strong as we had no net debt at year-end. The company generated $101 million of free cash flow during 2017, a 10% increase versus prior year. The company entered into a $350 million unsecured revolving line of credit in January 2018, which will provide the company with flexibility to fund future growth opportunities.

In 2017, we also increased our cash dividends for the 50th consecutive year, placing us in a very select group of companies.

Beginning on Slide #12, Quinn will now address our path forward to further increase shareholder value.

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

Thank you, Matt. After record results in 2016 and 2017, we believe our Surfactant business will continue to benefit from our diversification efforts into Functional Products, new technologies, expanded share into our broad customer base globally and the stabilization of commodity surfactant volumes.

However, headwinds in our North American Polymer business related to last year and lower margins will continue to challenge us in 2018. Results will benefit from the lower U.S. corporate tax rate. Longer term we believe that our strategy to leverage our market leadership positions to diversify our products and end markets, to collaborate with customers on new chemistries and to focus on operational excellence will drive shareholder value.

Turning to Slide #13. We believe that our market leadership position in several of our businesses is a strong foundation from which we can grow. First, we are the largest producer of anionic and amphoteric surfactants for the merchant market in the Western Hemisphere. And we will advance this position with the acquisition of the BASF plant and associated business in Ecatepec, Mexico. We believe our commodity anionic position should stabilize and potentially grow in 2018.

Next, we are the second-largest supplier of biodegradable fabric softener actives globally. Esterquats are the preferred technology in the developed world and are being adopted in the developing world. With plants in all 4 regions of the world, Stepan is positioned to capture market growth.

Finally, as a leading producer of rigid polyester polyols globally, we remain optimistic about the continued growth of the market due to increased insulation standards, energy-conservation efforts and growth in construction.

Although we experienced headwinds in our North American Polyol business during 2017, our European business remains strong.

Now turning to Slide #14. Our diversification efforts continue to be a key component of our long-term strategy. First, over the last several years, we have worked very closely with many large agricultural companies, and we believe Stepan chemistries will be included in many of their product launches over the next 36 months.

With regards to surfactant chemistries for oilfield, Stepan has a relatively low market share today. But we have significant opportunities to grow. Stepan's portfolio of chemistries including biocides and foamers are well suited for use in the production of oil. And in fact, volumes on these chemistries grew over 20% last year, albeit from a small base.

Next, growth within the Tier 2 and Tier 3 customer base continues to be a key priority for our Surfactant business. And our sales to this segment grew 8% in 2017.

Our Surfactant customer portfolio includes many large consumer product customers, which cover a significant part of our overhead. But today, Tier 2 and Tier 3 customers generate 35% to 40% of our Surfactant operating income. As such, our strategy to expand this segment to reach, to delight and to acquire more new customers, local heroes, if you will, around the world is the top priority for our Surfactant team.

Our knowledge and expertise in applications within the consumer product industry positions us well to help smaller companies create products so that they can compete and win in their local markets. In order to reach these customers effectively, we are adding sales personnel and enhancing our digital strategy.

Finally, with respect to our CASE Polyol business, we experienced double-digit growth in 2017. We remain optimistic about the growth of the global market and our business, in particular.

Production from our new specialty polyol reactor in Poland, which began production in the fall of 2016, contributed to the strong volume growth during 2017. In addition, a new specialty reactor in Columbus, Georgia began production in January of this year.

Turning to Slide 15. Collaborative chemistry is a key foundation of our long-term strategy. First, as a leader in the Rigid Polyol market, we continue to work on developing the next generation of value-added technologies for our customer base. We are excited about a few advances in our research pipeline today. We continue to innovate and create more environmentally friendly green solvent chemistries, including our partnership with Elevance, a metathesis-based technologies for the agricultural market. We recently launched a new solvent for the personal care end market that allows customers to replace more expensive solubilizers while maintaining performance and reducing cost for liquid cleansing applications, such as shampoo, body wash and hand soaps.

Finally, within the oil market, stimulation segment is projected to grow at 13% per year over the next 5 years. Although U.S. oil producers have reduced the cost of hydraulic fracking over the last decade, new chemistries can help reduce production costs further. Stepan has developed patent-pending technology for use in fracturing including flowback modifiers and friction-reducer boosters that offer significant cost advantages. Use of biocides is growing in the fracturing market due to regulations that restrict the use of freshwater, which should provide opportunities for our biocidal quaternary products as is in blends.

Turning to Slide 16. Our continued focus on operational excellence is a key aspect of our long-term strategy. We continue to actively pursue opportunities to reduce excess capacity in our networks. Our 2017 results benefited significantly from previous actions in Canada, Brazil and Singapore, and will from our plans to restructure our Fieldsboro plant. We will continue to examine our asset base for opportunities to further optimize and improve our capacity utilization and more effectively serve our customers around the world.

Next, we are delivering on our plans to increase our polymer production capacity by focusing on process improvements. We recently completed debottlenecking project at our Wesseling plant, which should increase capacity by 20%. We believe we have further opportunities to increase our polyol capacity at our Millsdale and Wesseling sites in 2018.

DRIVE, our internal efficiency program, is now ingrained in our culture and is part of the way we do business. The DRIVE program will continue to focus on supply chain optimization, procurement opportunities and SG&A expense reduction.

Finally, we will continue to focus on improving Stepan's working capital and free cash flow by standardizing and streamlining our processes and by optimizing our inventory position.

The market provides challenges and opportunities. We feel we are well positioned to capture opportunities for you, our shareholders.

This concludes our prepared remarks. At this time, we would like to turn the call over for questions. Lena, please review the instructions for the question portion of today's call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Mike Harrison with Seaport Global Securities.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

Just looking at the Surfactants business and the site closure that you announced. Can you walk through the timing and the expected savings related to that closure in New Jersey? And how does capacity utilization look in North America after this action is complete?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

So let me just talk about 2018 going forward. If we look at 2018, the cost savings that we will generate will primarily be offset by some of the transition costs in 2018. We anticipate it to be beneficial in 2019 going forward. So minimal impact in '18. In terms of capacity utilization of our North American network, we're getting to a position where we think we still have some excess capacity that allow us to grow in the marketplace. But we have a comfortable amount of excess capacity today the way I would describe it.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

All right. And looking at the Latin America business, you seem to be mentioning that the Brazil business contributed to the growth year-on-year. What -- can you just kind of walk us through what the underlying growth has been in Latin America? I know that's been a good business at times, but had some challenges more recently.

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

The growth that we're experiencing is primarily coming from 2 areas. One is continued growth in the agricultural end market, and the second is the expansion of our Tier 2 and Tier 3 customer base, selling more of Stepan products to the business that we acquired, selling more Stepan products to those customers, and also growing the number of customers where we're providing services.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

All right. And then on...

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

And those 2 will perform well in 2018.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

All right. And then on the Polymers business, just trying to dig in a little bit on the challenges that you're dealing with in North America. You mentioned some share losses. But is the weakness there primarily volume related and therefore, related to fixed costs or throughput? Or are you also seeing pricing competition that's weighing on your margin there?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

Yes. We are experiencing both. So we have -- I would say, the decline in that business is equally split between volume loss and margin loss.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

All right. Last question from me is just on the CFO search front. Obviously, you guys have a lot going on in terms of internal initiatives and growth initiatives. Just wondering if you can kind of walk through the qualities or skill sets that you're going to be looking for in a new CFO?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

So, yes -- so we are out in the marketplace looking. We have seen a number of very strong candidates and have a couple of them coming back in for the second round of interviews. And we'll also probably look at a few more coming in the door for the first time. So we've seen some very high-quality candidates that have great financial acumen. Some of them have investor experience. Others do not have as much investor relationship experience. But we're very excited about the people that we've had an opportunity to talk to so far.

Operator

(Operator Instructions) Our next question comes from the line of David Stratton with Great Lakes Review.

David Michael Stratton - *Great Lakes Review - Research Analyst*

Your DRIVE benefits, you say that's ingrained in the culture now. What kind of benefits can we expect to realize or see realize in this year and going forward? I know that previously it was around $10 million. Is that the expected run rate going forward? Or do you see that increasing, decreasing? Just kind of help us think about that.

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

Yes. So every year we have an objective that's passed on throughout the company that we want to try to generate $25 million of benefits from our DRIVE program. And we break that down into kind of which we're looking for at least $10 million of cash savings. Generally targeting kind of a number little bit higher than that. So $10 million to $15 million of cash savings, $25 million of benefits. And we look at that trying to offset other inflationary aspects of our business. So we feel good about the opportunities in the pipeline, and we believe that will help us maintain our current cost structure.

David Michael Stratton - *Great Lakes Review - Research Analyst*

Great. And then you mentioned inflationary aspects. Can you kind of give a little commentary around where you see your input prices going as we move into the 2018?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

Yes. I think generally speaking with the improving economy, we would tend to think that most of our input prices would potentially increase. As you are aware, and I think as most shareholders are aware, that we have a large percent of our contracts are tied to and include raw material pass-through agreement. So we believe we can maintain our margins, potentially increase those in the Surfactant market in 2018. But we do believe that there will be some challenges to do that in our Polymer business.

David Michael Stratton - *Great Lakes Review - Research Analyst*

All right. And then one final one from me. Given the current rising interest rate environment, is there any impetus that you see to may be take on a little debt just to lock in some fixed rates at these otherwise historically low rates? Or are you happy with the current capital structure and don't see that need?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

I believe, we borrowed some more money at a fixed rate going back to 2016. I think we...

Matthew John Eaken - *Stepan Company - Corporate Controller, Interim VP & CFO*

That's correct.

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

So we got another, -- I can't remember exactly off the top of my head, but it was like $150 million at a relatively low fixed rate in 2016. As you know, we expanded our revolver access to cash significantly in January of this year. So I don't see getting additional fixed debt at this point in time. But we will look for opportunities to spend some of the money that we do have to increase our opportunities to grow.

David Michael Stratton - *Great Lakes Review - Research Analyst*

And what's your fixed floating mix right now as it stands with your revolver?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

I'm not sure of that off the top of my head. So we can get back to you on that, David.

Operator

Our next question comes from the line of Curt Siegmeyer with KeyBanc Capital Markets.

Curtis Alan Siegmeyer - *KeyBanc Capital Markets Inc., Research Division - Associate*

Just in terms of your outlook for the Polymer business in 2018, the impacts from the customer share loss didn't seem to be too obvious in the numbers. So just as you kind of think about that going forward, is that something that you expect to be able to offset as the year progresses and see growth in that business? Or is that something that you think is going to prevent the business from growing in 2018?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

If we look at our Polymer business overall, we would anticipate very modest growth from a volume perspective in 2018.

Curtis Alan Siegmeyer - *KeyBanc Capital Markets Inc., Research Division - Associate*

Got it. And then just in terms of your balance sheet strength, what would you say is the most likely use of your balance sheet capacity in 2018 and beyond? Have you seen anything from an M&A standpoint that might drive you to be a little more opportunistic there?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

We want to be strategic. We don't necessarily want to be opportunistic. We want to make sure we're buying something that is consistent with our long-term strategy. So we do want to be more acquisitive. We have a healthy balance sheet today. We've got cash to spend. We will look at funding some significant internal organic opportunities as well as we will look at and consider acquisitions. As you know, the multiples in the marketplace today for chemical acquisitions are relatively high. So we want to make sure that we're prudent in spending our shareholders' money carefully and generating a return on that. In 2018, we will probably slightly increase our share buyback as well.

Operator

There are no further questions at this time.

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

All right. Well, thank you for joining us on the call today. We very much appreciate your interest and ownership in Stepan Company, and we look forward to reporting to you on our first quarter 2018 call. Have a great day. Thank you.

Operator

Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your line.
